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Forfaiting

An Introduction

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Forfaiting is a trade finance technique which has attracted growing interest in both the banking sector and the financial press of export-orientated countries over the last years.

This is certainly due to the fact that in many cases it has proven to be the most efficient instrument when it comes to export finance.

Our aim is to familiarise both bankers and exporters with the concept of forfaiting.

Contents

1. Introduction

1.1 Definition of Forfaiting

Forfaiting is the term generally used to denote the purchase of obligations falling due at some future date, arising from deliveries of goods and services - mostly export transactions - without recourse to any previous holder of the obligation.

The forfaiter will deduct interest (discount) in advance for the whole period of credit and disburse the net proceeds immediately. The exporter thus virtually converts his credit-based sale into a cash transaction. His sole responsibilities are manufacturing and delivery of the goods, thus creating a valid payment obligation of the importer.

1.2 Historical Development of Forfaiting

The origins of the forfaiting market lie in changes in the world economic structure during the
early sixties, when trade between Western and Eastern Europe was re-established. The growing importance of trade with developing countries in Africa, Asia and Latin America boosted the forfaiting market to an international level.

1.3 Advantages of Forfaiting

1.3.1 <u>100 % Risk Cover</u>

FINANZ AG ZÜRICH ("the forfaiter") fully covers the following risks associated to any export:

Country Risk (Political & Transfer Risk)

We absorb the full political risk without recourse or residual liability.

Extraordinary state measures or political incidents like war, revolution, invasion or civil unrest,
which could block or unable payments.

Inability or unwillingness of states or other official bodies to effect payment in the currency agreed upon - including the risk of moratorium.

Currency Risk

Floating exchange rates can have the effect of changing the contract value by a considerable amount when converted into the exporter's own currency, and can lead to a loss for the eventual holder of the claim.

Commercial Risk

Inability or unwillingness of the obligor or guarantor to fulfil its obligations on due date.

Interest Rate Risk

All forfaiting cost (discount, days of grace, commission) are binding and remain unchanged during the whole financing period.

1.3.2 Instant Cash

We allow you to generate instant cash which relieves your balance sheet and improves your liquidity. Your credit sale is transformed into a cash sale.

1.3.3 Flexibility and Simplicity

Simple documentation is generally achieved even for tailor-made financing solutions.

Complete credit administration and collection including relevant costs will be handled by the forfaiter.

1.4 Forfaiting vs. Factoring

The terms *factoring* and *forfaiting* have been mixed up frequently. Factoring is suitable for financing several and different smaller claims for consumer goods with credit terms between
90 and 180 days, whereas forfaiting is used to finance capital goods exports with credit terms between a few months and seven years.

Factoring only covers the commercial risk, whereas forfaiting additionally covers the political and transfer risk.

2. General Aspects of Forfaiting

2.1 Repayments / Amounts

Most likely repayment will be by periodic instalments. Where debt is evidenced by promissory notes or bills of exchange, a series of drafts will be issued, usually at six-months intervals.

Forfaiting applies to amounts of approx. US Dollars 500'000.00 and above.

2.2 Currency

The debt is normally denominated in US Dollars, German Marks or Swiss Francs, although in principle any other currency may be possible as well. Since the cost of forfaiting is for the most part determined by the forfaiter's funding cost (see 3.1), a weak currency would make such a forfaiting transaction just too expensive. It is essential that payments be made in effective currency. This means that the debtor may not pay in another
(e.g. his local) currency. To ensure this, the drafts will always carry the effective clause (see 2.4).

2.3 Discounting

The forfaiter will discount the drafts after the exporter has delivered the goods to the importer and handed over the required documents to the forfaiter.

The discount (interest) will be deducted from the face value (nominal) of the drafts and the resulting net proceeds will be paid out immediately. Please refer to para 3.1 for more details about discount rate.

2.4 Type of Instrument

<u>Promissory Note / Bill of Exchange</u>

The great majority of forfaitable obligations take the form of either promissory notes issued by
the debtor in favour of the beneficiary or bills of exchange drawn by the beneficiary on and accepted by the debtor. These drafts will generally be guaranteed by a bank aval or a separate bank guarantee of the debtor's bank. The first reason for the predominance of these forms of debt instrument is a matter of familiarity. Long experience in dealing with such paper has led to considerable ease of handling by all parties and generally facilitates a quick and uncomplicated transaction.

The second advantage is the internationally agreed legal framework based upon the International Convention for Commercial Bills established by the Geneva Conference of 1930; this provides a clear code of practice which was later adopted by the laws of most trading countries.

"Without Recourse" Clause
By transferring the drafts, the exporter also transfers his claim to the forfaiter. This is done by
an endorsement on the back of the draft, the exporter being the endorser and the forfaiter being the endorsee. A sample endorsement would read "Please pay to the order of *forfaiter* without recourse - *signed exporter*". This clause excludes the endorsee's right of recourse against the
previous holder of the draft - the main characteristic of forfaiting.

"Effective / Net of Deduction" Clause

All drafts should bear this clause which ensures that payment may only be effected in the currency agreed upon and not in any local currency. The clause will read "effective payment to be made in *United States Dollars* only, without deduction for and free of any tax, impost, levy or duty present or future of any nature." A draft bearing this clause is issued "in international format".

Book Receivables / Letters of Credit

Letters of credit with deferred payment clause can be forfaited as well. However, transactions tend to be more complex, since all maturities are evidenced by a single document, made out in favour of the beneficiary. The obligation is often not transferable without specific permission from the obligor.

2.5 Forms of Bank Security

Guarantee and Aval

As mentioned above, drafts will generally be guaranteed by a bank aval or a separate bank guarantee. The guarantor will usually be an internationally active bank resident in the importer's country and able to ascertain the importer's creditworthiness first-hand. This security is important for the exporter, as it confirms the client's ability to fulfil his obligations. Guarantees and avals are essentially similar, both being in their simplest form a promise to pay a certain sum on a given date in the event of non-payment by the original debtor. In the case of a guarantee, the promise takes the form of a separate document signed by the guarantor setting out in full all conditions relating to the transaction, whereas an aval is affixed and duly signed directly on each promissory note or bill of exchange.

An aval makes the avalizing bank primary obligor where a guarantee does not. Besides, an aval is transferable by nature but a guarantee must state tat it is unconditional and fully transferable.

The simplicity and clarity, together with its inherent abstractness and transferability makes an aval the preferred form of security for forfaiting.

Export Risk Insurance

Claims covered by export credit agencies (ECA), e.g. EXIM Bank, ERG, Hermes, may of course also be forfaited. The discount rate would be reduced accordingly. Unlike an ECA the forfaiter will be able to purchase the total claim without restriction.

3. Technical Aspects of Forfaiting

3.1 Cost

Discount Rate

The claims will be discounted at an all-in discount rate. The rate is usually quoted as margin over Libor (funding cost) and is made up of the following:

- *Cost of covering commercial, country and interest rate risk* (see para 1.3)
- *Cost of funds based on the Euromarket rates (LIBOR)*

Grace Days

Grace days are added to each maturity when calculating interest. These will compensate for delays in payment that are common in certain countries.

Commitment Fee

Exporters will often need a forfaiter's firm commitment to purchase a claim long before the delivery of goods. A commitment fee will then be charged from the day of commitment until disbursement.

3.2 Documentation

As mentioned earlier, documentation is usually simple and straight forward. The following will apply to a claim evidenced by drafts:

- Promissory Notes / Bills of Exchange in international format avalized by a bank
- Conformed copy of underlying L/C including all amendments (if any)
- Conformed copy of commercial invoice and shipping documents (Bill of Lading)
- Confirmation of the authenticity and validity of all signatures appearing on the documentation

In case the claim will be evidenced by a letter of credit, the following will apply:

- Conformed copy of underlying L/C including all amendments
- Conformed copy of commercial invoice and shipping documents
- Letter of assignment of proceeds in favour of the forfaiter
- Notification of assignment to the L/C issuing and advising bank as well as their relevant acknowledgement
- Confirmation by the L/C issuing and advising/confirming bank that they accept the forfaiter as the new beneficiary under the L/C and that they will pay at maturity directly to him.
- Confirmation by the L/C issuing and advising/confirming that documents under the L/C have been taken up without any reserve
- Confirmation of the authenticity and validity of all signatures appearing on the documentation

3.3 Guarantee Obligation of the Exporter

The exporter is obliged to meet all terms and conditions agreed to in the forfaiting agreement, i.e.:

- to duly fulfil the basic agreement (delivery of forfaited goods)
- to deliver authentic documents to the forfaiter

3.4 Important Requirements

Information Checklist

To be able to submit a firm offer the forfaiter needs the following information from the exporter:
- Currency, amount and financing period
- Country of risk
- Name and location of the guarantor
- Document (promissory note, bill of exchange etc.)
- Form of security (guarantee or aval)
- Tenor and repayment schedule (i.e. amounts and maturities)
- Exporting goods
- Delivery date of goods
- Delivery date of documents
- Necessary approvals and licences (import licence, transfer documents etc.)
- Domicile for payment of the debt
- Name of importer and exporter

The forfaiter can often quote his indicative risk premium, even if not all the details of the deal are known.

4. How Interest is calculated

1) Calculate the total number of days between disbursement and maturity; adjust for non-working days and add the grace days.

2) Calculate the number of whole year periods (for annual yield) or 183-/182-day-periods (for semi-annual yield)

3) Calculate a factor as described below (basis 365/360)

4) The face value is divided by this factor to give the net value (multiplied in the case of Straight Discount)

Discount-to-yield annually compounded

$$AnnualYieldFactor = \left(1 + \frac{Y}{100} \times \frac{365}{360}\right)^{N} \times \left(1 + \frac{Y}{100} \times \frac{D}{360}\right)$$

1) Y = Annual Yield Rate
N = Number of whole years (365 days)
D = Number of odd days

Discount-to-yield semi-annual compounded

$$SemiAnnualYieldFactor = \left(1 + \frac{Y}{100} \times \frac{183}{360}\right)^{N1} \times \left(1 + \frac{Y}{100} \times \frac{182}{360}\right)^{N2} \times \left(1 + \frac{Y}{100} \times \frac{D}{360}\right)$$

2) Y = Semi-annual Yield Rate
N1 = Number of 183 day periods
N2 = Number of 182 day periods
D = Number of odd days

Straight Discount

$$StraightDiscountFactor = \left(1 - \frac{\%}{100} \times \frac{D}{360}\right)$$

3) % = Straight Discount Rate
D = Number of days

FINANZ AG ZÜRICH is happy to provide you with an Excel spreadsheet that calculates both annually and semi-annually compounded discount-to-yield. It may be downloaded from our Website http:\\www.finanzag.csfb.com.

5. Sample Documents

5.1 Bill of Exchange

A bill of exchange has the following characteristics:

per aval for account of the drawee

Bangkok Import Bank, Bangkok

---

accepted

Import Corporation, Bangkok

Rome, 15 October 1997 — *USD 2' 000' 000.00*
(place and date of issue) — (currency and amount in figures)

On *15 October 1998*

for value received, pay **against this bill of exchange**

to the order of *Export Limited, Rome*

the sum of *USD twomillion 00/00* -

effective payment to be made in *United States Dollars* only,
(*type of currency*)

without deduction for and free of any tax, impost, levy or duty present or future of any nature.

This bill of exchange is payable at *Bangkok Import Bank, Bangkok*
(domicile)

Drawn on: *Import Corporation, Bangkok*

Export Limited, Rome

(signature of drawer)

5.2 Promissory Note

A promissory note has the following characteristics:

Bangkok, 15 October 1997 ____ *USD 2'000'000.00*
(place and date of issue) (currency and amount in figures)

On *15 October 1998* ____ (date) fixed

for value received, I/we promise to pay **against this promissory note**

to the order of *Export Limited, Rome*

the sum of *USD twomillion 00/00* -

effective payment to be made in *United States Dollars* ____ only,
(type of currency)

without deduction for and free of any tax, impost, levy or duty present or future of any nature.

This bill of exchange is payable at *Bangkok Import Bank, Bangkok*
(domicile)

Import Corporation, Bangkok

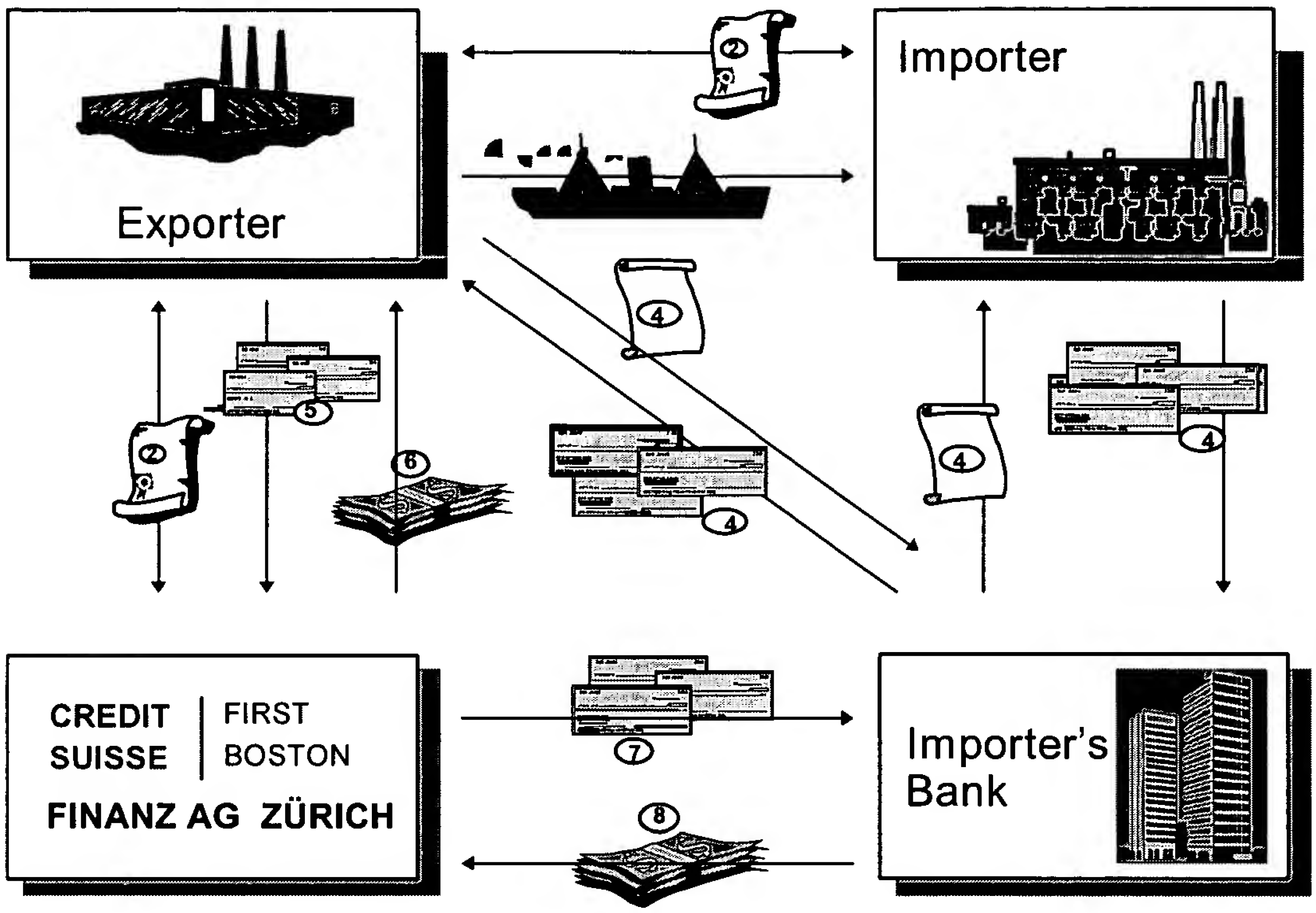
____
(signature of the maker)

per aval

Bangkok Import Bank, Bangkok

____

6. Flow Chart of a Typical Transaction



(1) Commercial contract

(2) Forfaiting agreement

(3) Delivery of goods

(4) Delivery of drafts against shipping documents

(5) Endorsement of drafts according to forfaiting agreement along with shipping and trade documents (e.g. invoice)

(6) Payment of the total amount of all drafts less discount (and fees, if any)

(7) Presentation of drafts for collection at maturity

(8) Payment of drafts at maturity

Rev. 1/98